Supreme Court of the United States

October Term, 1923

No. 213

HENRY V. CUNNINGHAM, SUCCESSOR TO EDWARD A. THURSTON, TRUSTEE OF THE BANKRUPT ESTATE OF CHARLES PONZI,

PETITIONER

v.

BENJAMIN BROWN AND OTHERS

BRIEF FOR PETITIONER

EDWARD F. McCLENNEN
WILLIAM R. SEARS
CLARENCE M. GORDON
For Petitioner

January, 1924

CASES AND AUTHORITIES CITED

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v.

BENJAMIN BROWN and others

SUMMARY

THE ERROR CLAIMED

The District Court, and the Circuit Court of Appeals for a different reason, have decided that the defendants did not receive payment of an obligation from the bankrupt, but that they merely recaptured from him their own property. It is respectfully submitted that this was error.

STATEMENT OF FACTS

In 1921 the trustees in bankruptcy of Charles Ponzi, for the benefit of upwards of four thousand creditors who had proved claims of approximately $3,440,000 (R. 71) and had pending claims which might increase the amount to upwards of $4,200,000 (R. 53), brought these six suits to recover preferential payments made to the six defendants by Ponzi on August 2, 3, and 4, 1920, within ten days before the filing of the petition in bankruptcy against him. Many hundred suits and claims by the same trustees against as many other persons, who were paid millions of dollars at about the same time, depend on the principle to be determined by this court in this case.

Ponzi, in December, 1919, began, with a capital of $150, the business of borrowing money on his promissory notes payable ninety days after date for 150% of the amount which he borrowed. This business continued without interruption until just before the bankruptcy petition against him, filed in the District Court for the District of Massachusetts on August 9, 1920.

Ponzi did not purport to receive money for investment for account of the lender, or to undertake any trust obligation to the lender. He borrowed the money on his credit only. The lenders did not entrust the money to him. His fifteen thousand to twenty thou-

sand dupes were his only sources for money (R. 8, 14). The inducement to them was 50% in ninety days. To explain his financial ability to pay his notes and his willingness to pay such a high rate, he spread the false tale that he, on his own account, was engaged in the business of buying international postal coupons in one or more foreign countries and selling them in other countries at a 100% profit, rendered possible by the different rates of exchange produced by the after-war distortions. He furthered the prospective lenders' avidity by adopting the practice of paying his ninety-day notes at the end of forty-five days, at the full 150%, and of paying any notes presented at any time before forty-five days at 100% (R. 8, 69). Within the eight months he took in $9,582,591.82, for which he issued his promissory notes for $14,374,755.59 (R. 53). These were issued to many thousand small lenders. He paid his agents a commission of at least 10%. This, with the 50% to lenders, made every loan cost him at least 60%. He was always insolvent, and became daily more so the more his business succeeded (R. 53).

The dates in 1920, and the amounts of the loans by the defendants, and the dates when Ponzi paid the defendants off, were as follows:

Name	Date of Loan	Amount	Date of Payment
Benjamin Brown	July 20	$600	August 2
	24	600	August 2
H. W. Crockford	July 24	1,000	August 2
Patrick W. Horan	July 24	1,600	August 4
Frank W. Murphy	July 22	600	August 4
Thomas Powers	July 24	500	August 3
H. P. Holbrook	July 22	1,000	August 4
		$5,900	

By July Ponzi was receiving loans at the rate of upwards of $1,000,000 a week (R. 8, 13). The receipts were deposited in various banks in Boston and other cities, in which Ponzi had accounts in different names (R. 53). During July the remains of these deposits were transferred to the Hanover Trust Company in Boston (R. 14, 71), in which he had accounts in three names, namely, (1) Conti, Pio; (2) Securities Exchange; and (3) Martelli, Lucy, Trustee (Ex. 24, p. 92; Ex. 25, p. 93; R. 13).

The first loan involved in these cases was made July 20th, and the last on July 24th (R. 7). It does not appear what became of the loans of July 20th and 22d (R. 71). (Note an apparently inadvertent finding *contra* (R. 15), unsupported.) Those of July 24th were deposited in the Hanover Trust Company (R. 67).

At the opening of business on July 19, 1920, the balance of Ponzi's deposit accounts at the Hanover Trust Company was $334,726.69; at the close July 24th it was $871,745.48 (R. 13). This sum was exhausted by withdrawals of July 26th, $572,098.77; July 27th, $288,172.95; July 28th, $905,719.10 (R. 72, 93). But notwithstanding this exhaustion, the account continued to show a balance because new deposits put the balance up in fluctuating amounts, generally diminishing, until there was a large overdraft on August 9th. The total withdrawals from July 19th to August 10th were $6,692,789.34 (R. 13).

All the lenders, including the defendants, who were paid off in August, had more than reasonable

cause to believe that Ponzi was insolvent (R. 15, 16). This is the finding of fact by the court who heard and saw the witnesses, and is abundantly supported by the evidence (R. 62, 54-65). A like conclusion on even less evidence was reached in *Lowell* v. *Ashton*, 272 Fed. 536.

The sums so paid out in August exceeded $2,500,000 (R. 94).

As the recipients knew of the insolvency, they had reasonable cause to believe that the payments would work a preference.

The defendants and others in receiving the August payments were not rescinding their loans because they had evidence that the loans had been induced by fraud. Several of the defendants do not even make such a claim. They were scared, and wanted to get paid before a break came (R. 55, 57, 61, 65). They were willing to accept anticipatory payment at 100% instead of waiting ninety dangerous days for 150%. They presented no charges of fraud to Ponzi when asking payment (R. 54-65). Ponzi, evidently in the hope of keeping the scheme afloat, had offered from the beginning, or from as early as April, to pay his notes forty-five days before maturity at 150% and at any earlier date at 100% (R. 8, 69). When the exposure of his scheme began, in the latter part of July, he reiterated this offer. It was not an offer to accept rescission on account of fraud. It was an offer to pay off in anticipation. He so announced publicly. He instructed his clerks "to pay notes as they were presented, matured or not" (R. 67, 68).

Between July 20th and August 5th about $3,500,000

went into the Hanover Trust Company. A great part of this came from new victims (R. 14).

The payment off of loans continued until, by August 9th, he had overdrawn his account $331,878.07 (R. 94). He did not stop there. He made further payments with some five hundred checks for which there were no funds and which were subsequently proved in bankruptcy (R. 12).

In bankruptcy the proofs of Ponzi's victims were made for 100%, and not for 150% (R. 74).

On these facts the District Court for the District of Massachusetts (R. 6; 280 Fed. 193) and the Circuit Court of Appeals for the First Circuit (R. 102; 284 Fed. 936) decided that the defendants had received no preference, because they got back only what was at the time, August 2d to 4th, 1920, their own money.

The case is here on a writ of certiorari granted by this court on the plaintiff's petition.

The original plaintiffs were James A. Lowell, William R. Sears, and Edward A. Thurston, trustees of the bankrupt estate of Charles Ponzi. Lowell and Sears resigned before the petition for certiorari was filed. Thurston died after the petition was granted. Henry V. Cunningham was appointed in his stead, and now prosecutes these suits.

PREFERENCE SECTIONS OF THE BANKRUPTCY ACT

"Sec. 60 (*a*) A person shall be deemed to have given a preference, if, being insolvent, he has, within four months before the filing of the petition, or after the filing of the petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class. Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required.

"(*b*) If a bankrupt shall have procured or suffered a judgment to be entered against him in favor of any person or have made a transfer of any of his property, and if, at the time of the transfer, or of the entry of the judgment, or of the recording or registering of the transfer if by law recording or registering thereof is required, and being within four months before the filing of the petition in bankruptcy or after the filing thereof and before the adjudication, the bankrupt be insolvent and the judgment or transfer then operate as a preference, and the person receiving it or to be benefited thereby, or his agent acting therein, shall then have reasonable

cause to believe that the enforcement of such judgment or transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value from such person. And for the purpose of such recovery any court of bankruptcy, as hereinbefore defined, and any State court which would have had jurisdiction if bankruptcy had not intervened, shall have concurrent jurisdiction."

The 1910 amendment of section 60 (*b*) has rendered it no longer necessary to establish the bankrupt's intent to prefer.

Cohen v. *Goldman*, 250 Fed. 599 (C.C.A. 1st).

ARGUMENT

The facts disclose that the defendants received a preference. They received money from the bankrupt within four months of bankruptcy, with reasonable cause to believe that he was insolvent. They gave nothing of value in return. In the opinion of the courts below, the defect in the plaintiff's case is that the defendants received, not payment of Ponzi's obligation, but a return of their own property. This, it is submitted, is error because—

First. The defendants did not get back their own property.

Second. The payments were of Ponzi's money.

Third. The decisions below violate the terms of the Bankruptcy Act and defeat its expressed purpose.

FIRST

THE DEFENDANTS DID NOT GET BACK THEIR OWN PROPERTY

The defendants' act was not a reclamation, and the money received was not the defendants' own.

(1) *The defendants' act was not a reclamation.* The courts below assume that the defendants' act was a rescission for fraud. In reality the defendants did not rescind for fraud. They did not charge to Ponzi that he had committed a fraud, and demand the return of their property on that account. They had no idea that the check which they received was their original money or its proceeds. They had no reason to suppose that it was drawn on a fund into which their money had gone. There is an opportunity for confusion in the fact that the defendants' original property was money. To avoid this, assume that one of the defendants had a thousand-dollar automobile instead of money, with which he bought Ponzi's $1500 note. At the end of July, Ponzi reiterated his announcement and instructed his clerks that he would pay his notes as presented, matured or not (R. 67, 68)—150% if matured, and 100% if not. The automobile seller prefers the smaller, anticipatory 100% payment to the risk of waiting for the 150%. He presents his note. The automobile is at the door. He gets $1000, not the automobile. The $1000, and not the automobile, is what the defendants at bar got. It was not the reclamation of the original property or of its proceeds. It was prepayment of Ponzi's debt. The defendants could not, by their unexpressed thoughts, characterize their acts. Their legal character was determined by the expressed

intent and action. Ponzi's offer was not to surrender property because he had obtained it by fraud. It was to pay his debts before they were due. The defendants' act was the acceptance of that offer. As long as Ponzi continued to pay, he properly described his conduct, not by saying that he had surrendered property which he had obtained by fraud, but by saying that he had paid his notes before maturity at a discount on request. His contracts with the defendants were performed as modified as to time and amount, and not rescinded.

(2) *The money received was not the defendants' own.* The defendants, like Ponzi's other dupes, loaned him money, relying on his future capacity to pay his debts to them. All the funds to Ponzi's deposit account at the Hanover Trust Company had come from these dupes. At the end of July 24th, when the last of the six loans in suit was made, there was on deposit to Ponzi's account at the Hanover Trust Company $871,745.48 (R. 93). If any part of that balance is to be treated as the defendants' money, or its traceable proceeds, then every dollar was the money of some one of the many dupes who had made loans. July 25th was Sunday. During the next three days there is no way of distinguishing between the money which had come from the defendants and the money which had come from the other dupes. The defendants had not then elected to rescind and to give up their 150% notes. In those three days Ponzi withdrew upwards of $1,750,000 (R. 93). Whose money did he withdraw? The courts below say that he did not withdraw any part of the $871,745.48 which had come from the defendants, but that instead he withdrew in

part the upwards of $1,200,000 which he had subsequently deposited on July 26th, 27th, and 28th (R. 93), realized from other dupes. It is respectfully submitted, for the reason later discussed, that this conclusion of the courts below is wholly unfounded.

The District Court bases its decision on the ground that because, some months later, Ponzi's other dupes proved claims in bankruptcy, they thereby waived their equitable rights and affirmed their original loans, and thereby retroactively made the money which Ponzi had received from them in those three days, July 26th to 28th, his own money, and the proving dupes mere lenders; so that none of their money, or its proceeds, remained in Ponzi's hands as their property (R. 14), but that it had, after August 9th, become Ponzi's own on July 26th to 28th. The Circuit Court of Appeals ignores this ground, but says that these same other dupes, by failure to reclaim their money after the disclosures of August 2d and before the filing of the bankruptcy petition on August 9th, thereby affirmed their original loans and became simple creditors, none of whose money, or its proceeds, was in Ponzi's hands as their property (R. 109); but that, at the close of the week beginning with the disclosures of August 2d and ending with the filing of the bankruptcy petition on August 9th, it had thereby all become Ponzi's own on July 26th to 28th.

Both courts seem to disregard the fact that Ponzi's withdrawals from this account on July 26th, 27th, and 28th got their legal character from the facts existing at the time. At that time, either the money in the account was Ponzi's money, or it was his dupes' money. If it was Ponzi's money, then his with-

drawals are chargeable to the deposits in the order of their date and therefore, by the end of July 28th, the entire balance which was in the bank at the end of July 24th, including anything that was traceable to the defendants, had been exhausted. If the deposit was Ponzi's dupes' money, then both courts agree that the withdrawals are chargeable in the same order. The rule is well settled. If none of the money in the fund belongs to the wrongdoer, "such withdrawals must, as among those claimants who are entitled to a charge upon the fund, be charged against the deposits in the order of their respective dates, the doctrine that the first withdrawals will be applied to the first deposits being followed among the claimants though not followed between them and their trustee. And when the amount subject to a charge in favor of a claimant has been diminished to any extent by the application against it of such withdrawals, it is not, nor is it ever, to be increased by any subsequent deposit by the wrongdoer not shown to have been the money of that particular claimant."

> *Hewitt* v. *Hayes*, 205 Mass. 356.
> *In re A. Bolognesi & Co.*, 254 Fed. 770 (C.C.A. 2d).
> *Empire State Surety Co.* v. *Carroll County*, 194 Fed. 593, 605 (C.C.A. 8th).
> *In re Mulligan*, 116 Fed. 715 (D.C. Mass.).
> *Clayton's Case*, 1 Mer. 572.

The thing to be determined was to what items Ponzi's withdrawals should be charged on July 26th, 27th, and 28th. That must be determined by the actual intention of Ponzi, or the intention imputed to him by

the law, on those days, and not later. The actual or the imputed intention which he then had, he then had. It depended on the present and past, and not on any future action or inaction of his other dupes, in August and thereafter. There was, in July, no basis whatever for exonerating the proceeds of the defendants' loans by meeting Ponzi's drawings on those days in July exclusively from subsequent loans of his other dupes.

If the balance, which included the defendants' loans, was once exhausted on July 28th, the money which had come from the defendants, and its proceeds, was gone from the fund. It did not return to the fund because other dupes subsequently proved claims in bankruptcy or because they subsequently failed to ask for payment when Ponzi's fraud had become public. If it be assumed that the defendants' loans are to be treated as trust funds before the defendants had rescinded, "the case involves an application of the rule that where one has deposited trust funds in his individual bank account and the mingled fund is at any time wholly depleted the trust fund is thereby dissipated, and cannot be treated as reappearing in sums subsequently deposited to the credit of the same account."

Schuyler v. *Littlefield*, 232 U.S. 707, 710.

The money which the defendants received on August 2d to 4th was money which had first come into the fund after July 28th (R. 13). It was not the defendants' own property, or the proceeds of the defendants' own property.

SECOND

THE PAYMENTS WERE OF PONZI'S MONEY

This is so because (1) in reality this is not a particular-fund case; and (2) even if it is, the money was Ponzi's at the time of payment to the defendants.

(1) *In reality this is not a particular-fund case.* Courts of equity, in the effort to protect *cestuis que trust* from the results of their trustees' embezzlements, have gone far in tracing the trust property and its distinguishable proceeds into conglomerate funds in the trustees' hands, but to do this, there must be a particular fund. It will often be that the general assets of the bankrupt trustee have been increased in a distinguishable amount by a particular misappropriation. But in such a case, if there is no particular fund, tracing is denied. As the *cestui's* property and its proceeds are gone, he must take his chances with ordinary creditors. He has no better right than the ordinary creditor. Such a creditor cannot have a preference, or keep a payment made just before bankruptcy during the known insolvency of the bankrupt. This is true notwithstanding the fact that the creditor's money made a distinguishable addition to the bankrupt's general assets and was intended to be applied promptly to the purchase of other assets of the same full value, to be turned over to the lender.

> *National City Bank* v. *Hotchkiss*, 231 U.S. 50:

"A trust cannot be established in an aliquot share of a man's whole property, as distinguished from a particular fund, by showing that trust monies have gone into it" (231 U.S. 57).

"What happened as between these parties was simply that all monies received in the course of the day from whatever source went into the firm's [Ponzi's] deposit account with the bank. So that, even if we take it, as a corollary of what was understood, that the use of the clearance loan was expected to enable the firm [Ponzi] to repay the loan, it does not appear to have been expected that the proceeds should be appropriated specifically to that end, but simply that the addition of such proceeds to the general funds of the firm [Ponzi] would enable the latter to pay within the time allowed" (231 U.S. 56).

Look at Ponzi's transactions in perspective: It was the merest accident whether the money of one lender went into one bank or another, or was used to pay agents' commissions in cash without going into any bank, or was used for any other purpose. Making distinction, because of any such accidents, between the rights of the different lenders, all of whom were equally dupes, is artificial, and does not produce a just result. The moneys were not received as trust funds. Neither Ponzi nor the lenders contracted for rights in particular property. Ponzi completed his wrong when he received the money. He did no wrong by putting it into one bank or another or by intermingling all the money received from all the dupes. He did not thereby embezzle. He did not commit any breach of trust. The only reason that there is any chance to talk about a particular fund is because, when the stress came at the end, all Ponzi's moneys were gathered by him into one bank. It is unreal to describe

as a particular fund this account, through which in only twenty days $5,000,000 flowed (R. 13), coming from perhaps fifteen or twenty thousand different small lenders, who had no idea that their moneys were to be put in any fund. In the common and in the legal sense, these bank accounts were Ponzi's general assets.

To make the rights of Ponzi's different dupes depend on tracing and particular-fund theories is straining fictions far away from the realities. It tends to an unfair distribution of insufficient assets among men in the same situation. The occasion for conjuring up fictions does not exist. The realities should prevail. The enormous accounts made up of vast numbers of rapidly moving and confused items were not a particular fund. They were general assets.

(2) *The money was Ponzi's at the time of payment to the defendants.* Ponzi got legal and equitable title to the money which he received from his dupes. In return they got (1) his promissory notes, and (2) a right to rescind and to recall this legal and equitable title because of his fraud. They could not have both the 150% notes and legal or equitable title to the 100% of money at the same time. Until they exercised their election to rescind and offered to return the 150% notes, the money continued to be Ponzi's.

Ponzi had, at all times until affirmative steps to rescind had been taken, a defeasible title to the money; and so far as there was any money left, this defeasible title passed to the trustee in bankruptcy.

Donaldson v. *Farwell*, 93 U.S. 631.

The case of an express trust differs. There the *cestui* has the equitable title from the beginning, without election. If the trustee transfers the property to a purchaser for value without notice, whether rightfully or wrongfully, the *cestui's* equitable title may attach to the proceeds, without election. But, where property or money is obtained by fraud, the vendor or lender has no title, legal or equitable, until he has exercised his option to reclaim the title and has offered to return the consideration.

Accordingly, when Ponzi made the payments to the defendants August 2d to 4th, he gave them money the legal and equitable title to which was then in him. His general estate which was to come to his trustee in bankruptcy was diminished *pro tanto*. It was not the defendants' money, for the reasons hereinbefore stated. Theirs was gone. It was not the money of the other unpaid dupes, because they had not elected to rescind. The District Court said: "All moneys received and paid by such creditor victims must be regarded, for present purposes, as Ponzi's money, i.e., money loaned to him" (R. 14). The Court of Appeals said: "Ponzi had a defeasible title to the money he received from his victims. One who has been induced to part with his goods or money through fraud has an election of remedies; he may rescind the transaction and recover his property, in which case title never becomes absolute in the vendee; or he may affirm the transaction and bring an action for damages, in which case the defeasible title of the vendee becomes absolute" (R. 109).

Indeed, both the courts below, in order to treat

the withdrawals of July 26th, 27th, and 28th as not inclusive of the defendants' money (within the principle of *In re Hallett's Estate*, 13 Ch. Div. 696, and other cases treating withdrawals from a mixed fund as made from the misappropriating trustee's own portion of the fund), held that the moneys received from non-rescinding dupes was Ponzi's money. Evidently what was true of July 26th, 27th, and 28th was also true of August 2d, 3d, and 4th.

If, when the right to rescind for fraud is acted upon, the original property or its proceeds are on hand, the receipt by the rescinding seller from the insolvent buyer, of money instead of the reclaimed property, is not necessarily a preference, because the seller gives 100% present consideration for the money in relinquishing his reclaimable property to the insolvent buyer. Virtually, he gets back his own property and resells it for cash to the insolvent buyer. That cash, received for a present full consideration, is not a preference.

> *Illinois Parlor Frame Co.* v. *Goldman*, 257 Fed. 300 (C.C.A. 7th).

If the property is gone when the opportunity for the rescission is acted upon, the contrary is true.

> *In re Midland Motor Co.*, 224 Fed. 368 (C.C.A. 7th).
> *In re Dorr*, 196 Fed. 292 (C.C.A. 9th).
> *In re Kearney*, 167 Fed. 995 (D.C. Pa.).

If, after trust property has been dissipated by embezzlement by the trustee, he, with the knowledge of his insolvency, takes equivalent property from his

general assets and gives it to the trust to repair the breach, the trust receives a voidable preference.

Clarke v. *Rogers*, 228 U.S. 534.

Even if it be assumed that Ponzi's conduct in depositing and dissipating the defendants' loans in July was a breach of trust, his payment to them in August was none the less a preferential payment from his general assets. The defendants did not give a present 100% consideration for the money received in August. Although they had a right of rescission, the property, with which they would be reinvested by exercising such right, was gone. The only thing which they had left was a claim against Ponzi personally. Whether that claim was the claim of a note-holder, or a claim for damages for deceit, or a claim for money had and received, or a claim for breach of the obligations of a constructive trustee, it was a chose in action only, and not a title, legal or equitable, to any property, whether chattel or money, in Ponzi's possession. Consequently the transactions of August 2d to 4th were the payments by Ponzi of claims *in personam* against Ponzi, and with Ponzi's money.

THIRD

THE DECISIONS BELOW VIOLATE THE TERMS OF THE BANKRUPTCY ACT AND DEFEAT ITS EXPRESSED PURPOSE

At the beginning of August 2d, all Ponzi's dupes who had not then been repaid were a single class. Each held Ponzi's note, and also a right to rescind the original loan for fraud, on offering to return the note, and to sue Ponzi for the money paid him or for damages for deceit. None had then rescinded or waived their right to rescind. The expressed purpose of the Bankruptcy Act is that, when a man is insolvent, all his creditors of the same class, who have reasonable cause to believe this, should share only ratably in his assets, and that the swifter and more forceful creditors should not get a preference.

Creditors are those who are dependent on the capacity of the bankrupt to meet his obligations. Those who have entrusted property to the bankrupt, have relied on his honesty, and not merely on his capacity to meet his obligations. Such men are entitled to their property if it can be found. Their rights are not affected by the Bankruptcy Act. But, if the property is gone, they perforce have become creditors only. They do not, however, fall into a different class merely because their claims arise out of a dissipation of trust property.

Clarke v. *Rogers*, 228 U.S. 534.

If a man has been induced to become an ordinary creditor, as Ponzi's dupes were, by fraud, they may have an election to convert themselves into owners of property in the hands of the bankrupt by rescinding their contract to give credit and recalling their

property. They do not become property owners until they exercise the right to rescind. They do not become property owners then, if their property and its proceeds are gone. They are no better then than the beneficiaries of an express trust. The only thing they have left is the right of a creditor.

With the utmost respect it is submitted that both the courts below have overlooked these distinctions, and have misapplied certain principles not themselves in controversy in this case. The propriety of this assertion is to be tested by reference to the opinions. The District Court says: "They claimed the right to rescind, gave up their notes, and took back the exact sums they paid in" (R. 10). . . . "Even if Ponzi paid them out money derived from those who, by subsequently proving their claims, either on their notes or for the amounts paid in, waived the right to rescind, his estate was not diminished; for the defendants' money, thus freed from the trust ex maleficio, remained in his possession as an exact offset. They relinquished their right to a sum the exact equivalent of the sum they received." . . . "Moreover, if the money with which Ponzi paid these defendants came technically out of a fund made up in whole or in part of money belonging to other cestuis who have not waived the torts, it is far from clear that such moneys ever became Ponzi's estate within the meaning of the Bankruptcy Act." . . . "It is plain, however the legal elements are stated, that Ponzi's 'estate,' if he had any, was neither increased nor diminished by the short-lived fraudulently induced contributions and withdrawals of these defendants" (R. 11). . . . "The defendants were not, when paid, creditors within the

meaning of Section 60 of the Bankruptcy Act; and also that Ponzi's estate was not diminished by these payments" (R. 12). . . . "It is admitted that of the large sums (about $3,500,000) deposited between July 20 and August 5 a great part came from victims who subsequently filed claims in bankruptcy of about $4,000,000, thus electing to treat themselves as creditors ab initio rather than as cestuis qui trustent." . . . "All moneys received and paid by such creditor victims must be regarded, for present purposes, as Ponzi's money, i.e., money loaned to him" (R. 14). . . . "I am unable to find that these defendants had reasonable cause to believe that they were getting a greater percentage of their claims (assuming for the moment that such claimants are creditors) than other claimants 'of the same class' " (R. 16).

(1) In fact, the defendants did not receive "the exact sums they paid in" unless this is used merely to define the amount.

(2) There is no evidence whatever that at the time at which they accepted payment "they CLAIMED the right to rescind." On the contrary, they accepted payment pursuant to Ponzi's offer and direction TO PAY HIS NOTES as they were presented, matured or not (R. 67, 68).

(3) It is true that Ponzi's estate was neither increased nor diminished by the short-lived, fraudulently induced contributions and withdrawals. But this is true of preferences generally. If an ordinary lender is paid no more than he loaned, the estate is not increased or diminished by his contributions and withdrawals. But it is diminished by the withdrawals. The same is true here.

(4) The statement that the defendants were not creditors seems to be in conflict with the decisions of this court.

> *Schall* v. *Camors*, 250 Fed. 6; 251 U.S. 239, 251.
> *Crawford* v. *Burke*, 195 U.S. 176, 187-193.
> *Tindle* v. *Birkett*, 205 U.S. 183.
> *Friend* v. *Talcott*, 228 U.S. 27, 38.
> *Kreitlein* v. *Ferger*, 238 U.S. 21, 27.

(5) One of the most perplexing parts of the decision is that which treats the proofs in bankruptcy after August 9th by the other victims, not on the notes, but for the amount originally obtained by Ponzi, as retroactively making the money which came from such victims, and which was deposited July 26th, 27th, and 28th, Ponzi's own money, although on those same days a distinguishable part of the prior bank balance is said to be, on those same days, the property of the defendants although they had not then rescinded.

The money on July 26th, 27th, and 28th must have been, at that time, either Ponzi's money, because the victims had not rescinded, or the victims' money. In neither event, either by expressed or imputed intent, can it be said that Ponzi, in drawing on July 26th, 27th, and 28th, was making his drafts applicable to new receipts from other victims to the exoneration of the proceeds of old receipts from the defendants; that is, that he intended to use the money of later victims and to hold inviolate the money of earlier victims (*In re Mulligan*, 116 Fed. 715, 722).

At the time that the defendants were paid, August 2d to 4th, the question whether there then remained

in the bank any money of the defendants must be determined by the facts which then existed. Those facts were that none of the unpaid victims had rescinded, and none of them had waived their right to rescind. Their later rescissions or waivers of the right to rescind could not affect the situation of August 2d to 4th.

How would the District Court have dealt with this case if the other dupes, whose loans went into the bank from July 26th to 28th, had not proved at all in bankruptcy? They could not pursue the defendants outside of bankruptcy, because the defendants had received the money in payment of a debt without notice that it was not Ponzi's money. The theory that the money, except that previously secured from the defendants, was all Ponzi's on July 26th to 28th would be exploded because that is based on the view that proof in bankruptcy by these dupes retroactively released their moneys to Ponzi *ab initio*. It would seem that the court would have followed the rule in Clayton's case, which it recognized as sound and applicable, that the withdrawals of July 26th to 28th were to be applied to the earliest deposits. This would have exhausted the balance of July 24th, including the money which came from the defendants. It would have followed that the defendants, when paid, did not get their own money, but, on the contrary, received Ponzi's money, and so a preference. Ponzi's other dupes, exclusive of the non-proving July 26th to 28th ones, would benefit accordingly. This seems the logical result of the District Court's theory. Then comes the bewildering consequence that whether the dupes of June to July 24th and July 29th to August 9th shall

get dividends out of the money received by the defendants depends on whether other dupes, whose money reached the bank July 26th to 28th, do or do not prove in bankruptcy. A theory that produces this result must be wrong.

In fact, Ponzi's dupes never waived their right to rescind. Picture, say, the 729th man in the line that stood on School Street on those hot August days, and who reached Ponzi's doorstep in time to get a check, which he rushed to the Hanover Trust Company to cash, only to find that the deposit was exhausted. His property was gone beyond recall. He enforced his check by proving it in bankruptcy. The 728th man —perhaps the defendant Brown—enforced his check by collecting it at the Hanover Trust Company before the deposit was exhausted. Now, picture the 729th man whiling away his penniless evening by reading 280 Federal Reporter, page 202, there to find that Brown elected to rescind, but that he, 729, elected to treat himself as a creditor *ab initio* rather than as a *cestui que trust*. He asks how he elected, and how he could have acted so as not to elect if he preferred not to elect. His money was gone. There was no fund. The only thing that he had was a claim for the money of which he had been deprived. The only thing which he could do was to prove for that money. There was no election. There was no choice.

The District Court treats the receipt of the check by Brown as significant of a rescission. The receipt of a check by No. 729 was no different. The enforcement of the check is treated as significant of a rescission by Brown. The enforcement of No. 729's check by proof was no different.

But even if 729 had not got as far as the doorway before the giving out of checks ended, it would make no difference. His money was gone. The only thing that he had was a claim. The only way of enforcing it was by proving that claim in bankruptcy. He made no election. He had no choice. He proved only for the original amount obtained from him. He did not prove on the 150% note, which would have been the case had he affirmed the transaction and elected to treat himself as a creditor *ab initio.*

In short, there was, by the proofs in bankruptcy, no affirmation of the original loan contracts; and if there had been this affirmation after August 9th, it would not have affected the question of whose money was drawn out July 26th, 27th, and 28th, or whose money was paid August 2d to 4th.

(6) The court's statement that the defendants, with reasonable cause to believe insolvency, did not have reasonable cause to believe that they were getting a greater percentage of their claims than other claimants of the same class is but a deduction from the court's earlier conclusion as to whose money was left in the bank. It falls with it. The defendants thought that they were getting checks on Ponzi's account at the Hanover Trust Company, and not on the defendants' account. They thought that his assets would be reduced that much, and that there would be that much less in Ponzi's bank account for other lenders.

The money, even if it could be traced to its original sources, was all Ponzi's money, to which he had a defeasible title which passed to his trustee in bankruptcy.

Donaldson v. *Farwell*, 93 U.S. 631.

The right to defeat that title belonged only to the victims. If they did not exercise that right, the title of the trustee in bankruptcy was absolute. The funds to which he had that absolute title were diminished to the extent of $5900 by the payments made therefrom August 2d to 4th to these defendants.

It is, of course, immaterial that this question comes before the court in a suit to recover a preference, instead of in the form of a suit by the present defendants against the trustee in bankruptcy to recover a specific $5900. The whole defense amounts to saying that the $5900 which the defendants received August 2d to 4th was their own money. If it was, and if they had not received it before bankruptcy, they would be entitled to receive it in full from the trustee after bankruptcy on the ground that it was not Ponzi's estate, but the defendants' estate, which had come into the hands of the trustee.

Donaldson v. *Farwell,* 93 U.S. 631.

Put in another way—suppose that the bankrupt's petition had been filed before banking hours on August 2d. Then the defendants would be entitled to receive from the trustee in bankruptcy that $5900, because by the assumptions made by the courts below it was their own money, and not a part of Ponzi's estate. But the many thousand other victims would be equally entitled to the upwards of $4,000,000 which was, by the same assumption, their money. There was no such money in hand.

The basic error of the courts below is the erroneous assumption that the $5900 was the defendants' money at the beginning of August 2d, and that they received

their own money. In fact they received Ponzi's money.

The Court of Appeals reaches the same result as the District Court, but on a fundamentally different theory.

(1) The Court of Appeals says: "From anything appearing in the record, all who invested between July 19 and August 4 may have received their money back, as much more was paid out than was received from investors during that period" (R. 110).

This statement is a misapprehension of the record. The District Court had said: "But it is admitted that of the large sums (about $3,500,000) deposited between July 20 and August 5 a great part came from victims who subsequently filed claims in bankruptcy of about $4,000,000" (R. 14). It is on this admitted fact that the District Court's "fiction" rests. The moneys paid out up to August were principally in the ordinary course of Ponzi's business. His offer and instruction was to pay his notes as presented, matured or unmatured. The heavy payments in the latter part of July were doubtless largely on matured notes. The men who loaned Ponzi a great part of about $3,500,000 between July 20th and August 5th did not receive payment before August 1st, but, on the contrary, proved in bankruptcy. By July he was receiving loans at the rate of about $1,000,000 a week (R. 8). There is no evidence that there was any general attempt by holders of unmatured notes to be paid until after the District Attorney's action on July 26th.

(2) The Court of Appeals says: "Ponzi had a defeasible title to the money he received from his victims" (R. 109). But the court makes no use of this un-

doubted and applicable principle. It means that, when Ponzi was making the withdrawals of July 26th, 27th, and 28th, he was drawing from funds to which he had title, and therefore his withdrawals are to be applied to his deposits in the order of their date, and not exclusively to deposits made after July 25th.

(3) The Court of Appeals says: "Ponzi's victims may be divided into two classes: those who became convinced that he was an imposter engaged in a fraudulent scheme and who rescinded their transactions and received back what they paid in; and those who for the sake of a large profit risked their money with him until it was too late to get it back. The defendants are typical of the first class. The creditors represented by the trustees include the second class. The second class having played the game and lost, the trustees are now seeking contribution in their behalf and that of other creditors, from the less daring but more fortunate first class" (R. 109). In applying this statement, consider the, say, 1143d man in that waiting line on School Street. His elbows were not strong enough to get him to Ponzi's doorstep before the moneys and the checks were gone. He seeks to discover why he has lost, by reading 284 Federal Reporter, page 943, only to find that the 728th man—possibly Brown—was less daring in running his chance, but that he, No. 1143, was one who, for the sake of a large profit, risked until it was too late, and, having played the game and lost, was to be deferred to the man farther ahead in the line. Look at the realities! All Ponzi's victims were deluded by the idea that Ponzi would pay them $1.50 for $1. Whether they are pitied or blamed for their credulity, they are all alike in this.

When the exposure came, they were scared, and hastened to get paid. There is not the slightest suggestion in the record that any of the unfortunates who have proved claims in bankruptcy failed to get their money merely because they decided after the exposure that they would still continue to run the risk. Yet the court says: "Those who could get their money back and didn't knowing as they must from the time the MacMaster's expose was published August 2, that Ponzi was an imposter, affirmed their investments and are not entitled to rescind. Their money became a part of the bankrupt's general estate" (R. 109). There were no such people. There is nothing in the record to suggest that there were any such. The court fixes the date August 2d. By August 3d the deposit account had gone down to $20,165.67. It rose again, but before the end of the week had gone down again to $13,391.32, and on August 9th—one week from the publication of the exposure—there was an overdraft of $331,878.07. During that week throngs of victims in long lines were pressing—sometimes riotously—to get paid (R. 75, 76). Under these circumstances it must have astonished No. 1143 to find that in some way the Circuit Court of Appeals thought that any of these victims had "affirmed" their investments.

The courts below assume that the moneys on deposit were the moneys of the victims, but that, by affirming the loans later those moneys became, at a time *before* the affirmance, the moneys of Ponzi, but never the moneys of Ponzi's trustee in bankruptcy. How can this be? The loans were loans, without any subsequent affirmance, and until disaffirmance. The defeasible title which Ponzi had, passed to his trustee

in bankruptcy, and that title covered not only the money left in the bank, but money of the same kind which had been withdrawn from the bank and preferentially received by particular victims with knowledge of Ponzi's insolvency.

The victims who did not disaffirm and defeat that title did not surrender their rights to other victims. They merely failed to disaffirm, and that left the original defeasible title of the trustee in bankruptcy an abolute title.

As the right to rescind for fraud, if the property remains, is not cut off by the occurrence of bankruptcy, but continues against the trustee in bankruptcy (93 U.S. 631), it follows that the defendants, if now entitled to keep this money, would have been entitled to take it all, from the trustee if it had come to his hands, even without rescission before bankruptcy. But all other dupes had a like right, and there was not enough money. In *Empire State Surety Co.* v. *Carroll County*, 194 Fed. 593 (C.C.A. 8th), two defrauded depositors in an insolvent bank sought to get specifically the remnant of the particular fund into which their deposits had gone. The fund was insufficient to pay all defrauded depositors. The other defrauded depositors had proved as common creditors in receivership proceedings. It was urged that this action freed the fund from their claims and left the fund as traceable proceeds of the deposits of these two depositors. But the court said (p. 607):

> "[12] It is true, as suggested by counsel, that the individual depositors who put these deposits into the bank after June 11, 1908, have not claimed preference in payment out of the proceeds of

their funds. But they are represented here by the receiver, who objects on their behalf that they are cestuis que trustent equally with the county, and that, while they are content in view of the fact that four-fifths of the claims against the bank are by claimants of this class to share the proceeds of its insolvent estate equally with all claimants, they protest against the taking of a share of their dividends to pay other cestuis que trustent of only equal rank in full. These sureties are appealing for their preferences to a court of equity which may and ought to require those who seek equity to do equity. And when, as in this case, the entire record shows that the allowance of a claim for a preferential payment out of the proceeds of an insolvent estate will be inequitable and unjust to the great majority in number and in amount of the creditors of the estate whose claims are equal in law and in merit to that pressed for preference, while the denial of this preference will violate no rule of law or of equity and work no injustice, but will tend to preserve that equality which is equity, the claim presents no equity and makes no appeal to the conscience of the chancellor for its allowance, and it must be denied."

Ponzi had title to all the money he received, from the time he received it, and, at the very best for the defendants, that title as to each dollar was good against all the world except for the right of each particular victim to reclaim his particular dollar or its proceeds. That victim's right of rescission did not

belong to any other victim. The defendant victims should get no benefit from it.

These adverse comments on the decisions below are not those of defeated parties alone. The Dean of the Yale Law School has criticized these decisions in a scholarly article in the Yale Law Journal for January, 1923, page 267, reprinted in full as an appendix to the brief in support of the petition for certiorari in this case. Judge Morton also reached a different conclusion without discussing the question of rescission in *Lowell* v. *Ashton*, 272 Fed. 536, an earlier preference case arising out of payments made by Ponzi under the same circumstances. The answer of one of the defendants raised the question as in the case at bar.

To reduce the details, while keeping the same essential facts, imagine a case: Ponzi, by false representations, induces the defendant Furst to discount his note, and thereby secures $5000, which he deposits in the Hanover Trust Company. Next, by the same false representations, he persuades one Seccond to discount another note, and thereby he obtains $5000 more, which he adds to this deposit, making the balance $10,000. He then withdraws $5000, with which he pays up some of his debts. Furst and Seccond, each ignorant of the other's dealings with Ponzi, learn that Ponzi is a fraud and insolvent and was so when he obtained the loan. Ponzi says he will pay his notes before maturity at the amount originally loaned. Furst demands and receives payment of $5000 from Ponzi in a check on the Hanover Trust Company, which he cashes, and thereby exhausts the account. A petition in bankruptcy is filed against Ponzi. Ponzi's trustee in bankruptcy sues Furst to recover the $5000

which he received as a preference. By the rule in Clayton's case, recognized by the courts below as correct, the first $5000 which Ponzi drew exhausted the money which had come from Furst and had been first deposited. Before Ponzi paid the second $5000 to Furst, Seccond could have reclaimed it, because it was obtained from him by fraud and could be identified as remaining in the deposit account. This right was cut off by the payment of the second $5000 to Furst who took it as a purchaser for value without notice of Seccond's right to reclaim it. Furst did not receive it as Seccond's money. He received it as Ponzi's. As the fund was exhausted before bankruptcy, Seccond has no fund from which to reclaim his money. Furst had no fund from which to reclaim his, because his part of the fund had been exhausted by Ponzi's first draft. When Furst got the second $5000, he had nothing but a claim. He got that paid in full with knowledge of Ponzi's insolvency. Ponzi's trustee is entitled to get back the payment for the benefit of Ponzi's general creditors. Seccond realizing that Furst is a bona-fide purchaser for value of the $5000, and that there is no money left in the account, proves his claim in bankruptcy for the $5000 without interest, and not on the note. The trustee's right to recover the preference cannot be defeated by the fact that Seccond has become one of the general creditors. The courts below say that Seccond and the other general creditors can have nothing, and that Furst can have it all. If Furst had not been paid, and Seccond had not reclaimed the money, the general creditors, including Furst and Seccond, would each have received, in dividends, a portion of the $5000. The preferential payment has deprived the general

creditors, including Seccond, of this dividend. It is the simple case of a voidable preference.

The theory of the courts below produces another impossible result: All the victims who were paid an amount equal to their original loan, after the exposures about the end of July, would be in the same position as the defendants. Each one of them sued by the trustee would defend as the defendants did below, on the ground that what they received was their own money or its proceeds. But each of these possible defendants does this by showing that the payments to the others from the fund were of Ponzi's money *ab initio*. As the whole deposit was exhausted by these payments, it results that EACH PART of this fund is a rescinding VICTIM'S MONEY, but THE SUM OF ALL THE PARTS is PONZI'S MONEY, and yet his trustee in bankruptcy can recover none of it, although it was all paid out to persons who knew that Ponzi was insolvent.

CONCLUSION

Looking at the realities: on August 1, 1920, Ponzi owed several million dollars which he had obtained by fraud from several thousand creditors. They were all of a kind. He was insolvent. They knew it. The Bankruptcy Act contemplates that they shall not get the better of each other by speed and strength. They ought all to share ratably in the insufficient assets. If the defendants and the thousands who were paid after August 1st keep the money, they get paid as much as they loaned, while the other four thousand, similarly situated, get a very small percentage. If the preferential millions are paid back, they will get a much larger percentage, and all will get the ratable treatment as of the end of July which the Bankruptcy Act contemplates shall be accorded all in like situation.

To let the lucky ones, who got there first, keep all at the expense of the no less worthy unlucky ones violates the equality which courts of equity and the Bankruptcy Act both seek to further.

Respectfully submitted,

EDWARD F. McCLENNEN,
WILLIAM R. SEARS,
CLARENCE M. GORDON,
For the Petitioner.

January, 1924.

[illegible]

Supreme Court of the United States.

October Term, [illegible].

No. 213.

HENRY V. CUNNINGHAM, SUCCESSOR TO EDWARD A. THURSTON, TRUSTEE OF THE BANKRUPT ESTATE OF CHARLES PONZI,

PETITIONER,

v.

BENJAMIN BROWN ET ALS.,

DEFENDANTS.

Defendants' Brief.

LOUIS GOLDBERG,
Attorney for Defendants.

ADDISON C. GETCHELL & SON, LAW PRINTERS, BOSTON.

Supreme Court of the United States.

October Term, 1923.

No. 213.

HENRY V. CUNNINGHAM, Successor to Edward A. Thurston, Trustee of the Bankrupt Estate of Charles Ponzi, *Petitioner*,

v.

BENJAMIN BROWN et als., *Defendants*.

DEFENDANTS' BRIEF.

Statement of the Case.

This case is before this court to review the decision of the Circuit Court of Appeals for the First Circuit affirming a decree entered by the United States District Court for the District of Massachusetts dismissing the bill in six cases brought by the trustees of Charles Ponzi to set aside as preferences certain payments made to the defendants.

The defendants' answers in substance set up the allegations that the designated sums of money were obtained by fraud, and as a result of such fraud these several defendants rescinded their contracts, thereby withdrawing their own moneys.

The defendant Brown further alleged that he was an infant at the time of the transaction and was still an infant at the time of the suit, and that $600 of the $1200 claimed by the trustees belonged to another infant, named Gross. This bill in equity was defended by a guardian *ad litem*.

Statement of Facts.

In December, 1919, Ponzi began in a small way selling 50 per cent ninety-day notes, representing in substance that he had discovered that, through the use of international reply postal coupons, he was able to make within a short period of time 100 per cent or more profit, and that he was generously sharing his profits with the public, who would furnish him money to manipulate in the foreign exchange. His scheme was a pure fraud and a swindle; his method of paying a large percentage was in making payments to earlier comers profits out of the contributions of the later ones. Acting upon such representations and rumors, these defendants deposited their moneys with Ponzi or his agents. At no time did Ponzi deal substantially in international coupons or any other speculations in foreign exchange.

The money invested with Ponzi by defendant Brown as it appears from the record is $600 on July 20, 1920, and $600 on July 24, 1920. The return check is dated August 2, 1920.

Defendant Brown, by Saturday, July 31st, became uneasy about his investment with Ponzi and decided to demand his money back, but when he appeared on that day at the office of said Ponzi at 27 School Street, he found the office closed, and so returned home to Revere, taking his notes with him, fully determined to demand the money paid by him on the following business day, August 2d, Monday. On August 2d he left his home at Revere at 8 o'clock in the morning with this fixed determination. He did not remember seeing the "Post" on that morning. His purpose was in no way the result of the article in the "Boston Post." On that day a check was given to him at the

office of Ponzi, which he cashed at the Hanover Trust Company.

It was further admitted by the plaintiffs that, of the $1200 thus received, $600 belonged to one Gross, who was also an infant and to whom defendant Brown gave $600 upon cashing the check. Gross deposited the $600 July 20th or 24th in Brown's name, without Brown's knowledge. Gross made the investment in Brown's name, fearing that his family would object if it learned of his investment, and for the same reason left the note with Brown for safekeeping. Brown knew nothing of the investment by Gross until later, when Gross gave him (Brown) his note to hold. Brown withdrew the money for both on his own initiative, returning $600 to Gross.

Ponzi stopped receiving money on July 26, 1920, and on August 9, 1920, an involuntary petition in bankruptcy was filed against him, and on October 25th of the same year he was adjudicated bankrupt. During the last few weeks of Ponzi's career he took in about a million dollars a week. He received from all the investors about $9,300,000. Claims to the amount of approximately $3,440,000 have been proved and allowed in the Ponzi proceedings by holders of these notes. These investors were allowed to prove, by the ruling of the referee, for the amounts only which they paid Ponzi, and not for the face value of their notes. Up to July 22d Ponzi had accounts at the Hanover Trust Company and at the Tremont Trust Company, but after that date he deposited all his receipts at the Hanover Trust Company. The defendant received a check of Ponzi drawn on the Hanover Trust Company; the amount of the check was the amount of the consideration paid on the notes. Three notes of $80,000 each, made by three different persons, were

discounted by Ponzi at the Hanover Trust Company, and the proceeds were credited to Ponzi's account on August 3, 1920, thereby increasing his balance to $240,000. Until August 3, 1920, the moneys he deposited in the Hanover Trust Company in Ponzi's several accounts were made up entirely of moneys deposited there directly in the Hanover Trust Company or first deposited in the outside banks and later transferred to the Hanover Trust Company.

The total amount of money in Ponzi's account at the Hanover Trust Company during the period covered by these transactions was five million two hundred sixteen thousand eight hundred thirty-eight dollars and thirty-five cents ($5,216,838.35), made up as follows:

Account in bank, morning July 19th	$334,726.69
Received from victims	3,726,660.96
Transferred from other banks or accounts	1,165,450.70
Total	**$5,216,838.35**
Withdrawals during period	4,833,165.15
Balance at close of business August 4th	
	$383,673.20

On July 22, 1920, Ponzi was requested by the president and treasurer of the Hanover Trust Company to take a certificate of deposit for some of his money then on deposit in that bank, telling him that the Fourth Atlantic National Bank, which did the clearing for the Hanover Trust Company, would not be able to clear his checks, if he should draw checks for the full amount of his balance. To protect the Fourth Atlantic National Bank he took a certificate of deposit

for one million five hundred thousand dollars ($1,-500,000). This $1,500,000 certificate of deposit was made up in the following manner: He signed six checks for $200,000, dated July 17, 1920, which were certified on that date by the Hanover Trust Company, and another check for $300,000, dated July 22, 1920; these checks were stamped on the back: "Hanover Trust Company, July 22, 1920, Pay Teller."

The plaintiffs stated in court that the above-mentioned certificate of deposit for $1,500,000 was split up into three certificates of $500,000 each, and one of these $500,000 certificates was used in payment of the three $80,000 notes and applied on an overdraft of some $200,000.

In this decision the District Court, among others, made the following findings of fact:

> "They claimed the right to rescind, gave up their notes, and took back the exact sums they paid in, so that their dealings with Ponzi neither increased nor diminished the amount of assets,—which remained for distribution exactly the same as if they had no dealings at all with him.
>
> "The defendants' moneys were deposited, not later than one day after their payment to Ponzi, in the Hanover Trust Company, with other moneys extracted from other victims by similar fraud.
>
> "The defendants' moneys went, on or almost immediately after the dates of payments, into an identified deposit in the Hanover Trust Company, and there remained until it was repaid to them by checks drawn as above set forth. In other words, so far as the defendants' rights are concerned, the trust fund in the Hanover Trust Company remained unaffected by the large deposits

and withdrawals between July 20th and August 5th.

"In addition to the moneys remaining in this consolidated account in the Hanover Trust Company, Ponzi had actually there on deposit $1,500,000 more, represented by time certificates of deposit taken out for the purpose of preventing embarrassment to the bank through which the Hanover Trust Company checks were cleared. While these certificates were negotiable, they were not in fact negotiated. They were grounded on moneys received prior to the earliest date here significant —July 20.

"If material, it is a fact that Ponzi had in this Hanover Trust Company during the period in question a deposit ranging from $2,500,000 down to a little over $1,500,000.

"The defendants had no reasonable cause to believe that the moneys received by them by payment of the checks drawn on the Hanover Trust Company did not come from the specific funds into which their moneys had gone."

Argument.

I.

Synopsis of Law Points on Main Issue.

To clarify the issues, let us test the contentions of the plaintiffs by the syllogistic standard.

The major premise is embodied in the Act of 1898 as amended, section 60, *a* and *b*.

To establish a conclusive minor premise the plaintiffs must prove, as of August 2, 1920:

1. Ponzi's insolvency.
2. A transfer to the defendant Brown.

3. A transfer within four months of bankruptcy.

4. A transfer of the bankrupt's property.

5. That the defendant Brown was a creditor, and that the effect of the enforcement of the transfer would enable the defendant Brown to obtain a greater proportion of his debt that any other creditor of the same class.

6. That the defendant Brown had reasonable grounds to believe the enforcement of said transfer would effect a preference.

If a single one of the foregoing elements fails, the plaintiffs are out of court, for this chain is no stronger than its weakest link. 1, 2, and 3 may be conceded without comment, but the facts as to the remaining elements are widely variant from a minor premise establishing a conclusion that a preference, by any interpretation of the term, has been established.

Let us remember that we are not dealing with a question of common law, controlled by no precedents, and which offers no recourse but widely divergent theses based on analogy, but with the hard and fast terminology of a statute; and that a proposition to fall within its purview must be predicated on the inexorable rule of statutory construction that its terms must be met by terms of identical import.

A notable illustration may be found in the recent case of *Pondreka* v. *Turner Falls Co.*, 241 Mass. 100, in which, on the finding that the death of the plaintiff's intestate was due to a wilful and malicious injury inflicted by the defendant, the court held that the fault of the defendant differed in kind and not in degree from the term "negligence" as prescribed by the death statute, General Laws, chapter 229, section 5, and that there could be recovery, observing that the

undoubted hardship could only be relieved by the legislature.

Elements 4, 5, and 6 either collectively or individually furnish a perfect analogy to the Pondreka case. The trustees do not and cannot satisfy the terms of the statute therein embodied. The burden of proof is distinctly upon them—

> Black on Bankruptcy (3d ed.), secs. 614 and 573;
>
> Collier on Bankruptcy (12th ed.), 868—

and their inability to sustain this burden epitomizes the failure of the propositions upon which they base their case.

They must show under 4, *supra*, by a preponderance of proof, that the money transferred to defendant Brown on August 2, 1920, was the property of Ponzi, and that there thereby was consummated a depletion of the funds available for general creditors. The record discloses that Brown, on Saturday, July 31st, becoming anxious for the safety of his financial venture, went to Ponzi's office for the purpose of rescinding his contracts and withdrawing the money paid in by him. Finding the office closed, on August 2, 1920, he received a check from Ponzi at his office, which he cashed on the same date at the Hanover Trust Company. It further appears that Ponzi's deposit exceeded the withdrawals of Brown's and the other defendants, his balance on August 2d being $121,436.21 and on August 4th $313,737.08. It also appears that the money paid to Ponzi by Brown was deposited by him not later than the day succeeding payment in the Hanover Trust Company, and although there were deposits and withdrawals by the bankrupt during the intervening time, the presumption is, where money

charged with a trust *ex maleficio* is mingled with the general funds of the debtor, that the debtor first exhausts his own before paying out trust funds.

Hewitt v. *Hayes*, 205 Mass. 356.
In re Hallett's Estate, 13 Ch. Div. 143.
Empire State Surety Co. v. *Carroll County*, 194 Fed. 593.
Importers' & Traders' Nat. Bk. v. *Peters*, 123 N.Y. 272.
Southern Cotton Oil Co. v. *Elliotte*, 218 Fed. 567.
Smith v. *Motley*, 150 Fed. 266.
Peters v. *Bain*, 133 U.S. 670.

In a word, the plaintiffs have failed to establish the element "property of the bankrupt." The defendant having exercised his right to rescind, the money was his own property, and he could maintain his title against all persons except one receiving it for value *bona fide* without notice.

Atwood v. *Dearborn*, 1 Allen, 483, 484.
National Bank v. *Insurance Co.*, 104 U.S. 54.
Bussing v. *Rice*, 2 Cush. 48.
Tiffany v. *Boatman's Institute*, 18 Wall. 375, 390.
Goodwin v. *Massachusetts Loan Co.*, 152 Mass. 189, 199, and cases cited.
Peoples National Bank v. *Mulholland*, 228 Mass. 152, 158.
Watchmaker v. *Barnes*, 259 Fed. 783.

In plain language the plaintiffs have nothing further than "a transfer of property of another than the bankrupt." Therefore element 4 fails and, *pari*

passu, element 5 suffers the same fate. Brown, having received back his own property, is not a creditor, and consequently the transfer did not operate to diminish the bankrupt's estate.

In *Hewitt* v. *Hayes, supra,* the court segregated in a distinct class parties who had chosen to prove their claims against the bankrupt estate as distinguished from those who had rescinded; the two remedies being utterly inconsistent and the latter being barred by the election. Not being a creditor at all, he has obtained nothing that belongs to creditors of the same class.

In the same line of reasoning, the suit of the plaintiff also lacks the ground of liability that the person receiving the transfer had reasonable ground for believing that preference had been made.

The rescinding party has merely exercised the right of reclamation. He stands in the shoes of an owner recovering his own as truly as does the plaintiff in replevin. Consequently he is chargeable with no knowledge as to his relative rights as against persons who, as against him, have no rights at all.

The misapplied authority and subjective criticism which make up the bulk of the plaintiff's argument fall far short of the preponderance of convincing proof which the plaintiffs must adduce before they can hope to establish element 6. Granted that the defendant Brown had reasonable cause to believe that Ponzi was insolvent, and that he, Brown, had obtained a greater proportion than those who proved their claims in bankruptcy, this does not show reasonable cause to believe that a preference has been made.

The plaintiffs cannot win under the statute, and a careful analysis of their argument shows a palpable effort to divert attention from the main issue, by attacks upon the decisions of the District Court and

Circuit Court of Appeals, which are so irrelevant that, while professing to effect a *reductio ad absurdum*, they have actually and literally begged the question, as will be shown under another head in this brief.

II.

The Far-Reaching Effect of the Decisions of the District Court and the Circuit Court of Appeals.

A careful examination of the opinion in each case shows that the settled law of Massachusetts has been followed. This case, as dealing with a preference, is not a bankruptcy case proper.

> Loveland on Bankruptcy (4th ed.), sec. 541.
> *Pond* v. *New York Exchange Bank*, 124 Fed. 992.

Section 60-*b* of the Bankruptcy Act, in connection with the recovery of a voidable preference provides: "And for the purpose of such recovery any State Court which would have had jurisdiction, shall have concurrent jurisdiction." This not being a strictly federal question, the District Court and the Circuit Court of Appeals will give effect to the common law of Massachusetts, the state in which the alleged preference was made, citing state and federal authorities in other jurisdictions (for corroborative purposes) in precisely the same way as a state court which, while lending chief weight to its own decisions, refers to decisions in other states. This fundamental principle is ignored by the appellants, who in effect ask this honorable court to overrule the decision of the Circuit Court of Appeals in the First Circuit by *Empire State Surety Co.* v. *Carroll County*, 194 Fed. 593. In other words, it is argued that the established law of Massachusetts be overruled in a federal court in the Dis-

trict of Massachusetts and following the common law of Massachusetts, by decision of a federal court sitting in the District of Iowa and following the law of Iowa in an Iowa case.

> "Turning now to the main issues: It is important, to keep clearly in mind that these are suits to recover voidable preferences and nothing else. On no other ground has this Court jurisdiction. (See Section 60-b of the Bankruptcy Act.) They are technical preference suits, and might have been brought in a state court and tried before a jury. The issues here are precisely the same as they would have been in the state court on the law side. In order to recover, the plaintiffs must fully prove their cases under Section 60 of the Bankruptcy Act. The issues here presented are quite other than those before the court in the Bolignesi cases, 254 Fed. 770, or in the Matthews case, 238 Fed. 785. See also In re Stewart, 178 Fed. 463."

The appellants stress the decisive character of *Clayton's Case*, 1 Mer. 572. On this point the Circuit Court of Appeals held as follows:

> "The plaintiffs call attention to the rule in Clayton's case, 1 Mer. 572, claiming it governs these cases. By this rule withdrawals from a fund belonging in equity to several persons, and insufficient to satisfy their claims in full, are charged against deposits to the fund in the order of the receipts of these deposits. Claimants share in the fund in the inverse order in which their moneys went into it.
>
> "The true application of the rule in Clayton's case is pointed out in re Hallett's Estate, 13 Ch.

Div. 143. It is there held that, if a person who holds money as a trustee or in a fiduciary character, pays it to his account at the bankers, and mixes it with his own money and afterwards draws out sums by checks in the ordinary manner that the rule in Clayton's case, attributing the first drawings out to the first payments in, does not apply; and that the drawer must be taken to have drawn out his own money in preference to the trust money.

"But if the fund into which trust moneys have been paid is insufficient in amount to satisfy all beneficiaries, then it is held (Frye, J.) that as between two cestuis que trust whose money the trustee has paid into his own account at his banker's, the rule in Clayton's case applies so that the first sum paid in will be held to have been the first drawn out.

"It does not appear that the money in the Hanover Trust Company was ever depleted to a sum insufficient to pay all of Ponzi's victims who sought rescission from that fund. The rule of Clayton's case is not applicable."

In *Hewitt* v. *Hayes*, 205 Mass. 356, 361, the court lays down the rule as to the presumption that withdrawals from a mixed fund were made from the trustee's own part of the fund, and not from the part consisting of the trust money, so long as there remains in the fund available for use any part of the trustee's own money, citing, among others, *National Bank* v. *Insurance Co.*, 104 U.S. 54, and *In re Hallett's Estate*, 13 Ch. Div. 143, adding:

"The rúle in Clayton's case that checks are to be applied against deposits in the order of their

respective dates has been modified to this extent, as is shown by the cases above cited . . . but it is said that our own recent decisions are at variance with this doctrine. We do not so consider. Little v. Chadwick, 151 Mass. 109, turned on the fact that the trust fund there in question could neither be identified nor traced into any specific fund; and the court said that it was not enough that it had gone into the general estate of the defaulting trustee. But it was expressly stated in the opinion and indeed was manifest that there was nothing in that opinion contrary to National Bank v. Insurance Co., or In re Hallett's Estate, 13 Ch. Div. 143. The same thing is true of Lowe v. Jones, 192 Mass. 94. It was really sought in that case to establish a trust in the general assets of an insolvent estate upon the ground that the proceeds of trust property wrongfully disposed of had gone into those general assets, and thus increased the amount of the estate. There is some authority for this statement, (See cases in 19 Harv. Law Rev. 519), but this court never adopted it, and we are not now disposed to do so. In O'Brien v. N. E. Trust Co., 183 Mass. 186 no one but the executrix of the deceased sheriff made any claim to the deposit. And see further Le Breton v. Pierce, 2 Allen 8; Andrews v. Bank of Cape Ann, 3 Allen 313; White vs. Chapin, 134 Mass. 230; Howard v. Fay, 138 Mass. 104; Attorney General v. Brigham, 142 Mass. 248."

It is respectfully submitted *Empire State Surety Co. v. Carroll County, supra*, is in the last analysis not at variance with the doctrine herein maintained. It holds:

"It is indispensable to the maintenance by a cestui que trust of a claim to preferential payment by a receiver out of the proceeds of the estate of an insolvent that clear proof be made that the trust property or its proceeds went into a specific fund or into a specific identified piece of property which came to the hands of the receiver, and then the claim can be sustained to that fund or property only and only to the extent that the trust property or its proceeds went into it. It is not sufficient to prove that the trust property or its proceeds went into the general assets of the insolvent estate and increased the amount and the value thereof which came to the hands of the receiver."

It is enough to point out that the excerpt from *Hewitt v. Hayes, supra,* reconciles its decision with every one of the Massachusetts cases cited. Moreover, the Eighth Circuit decision reaffirmes the doctrine as to the identification of a trust fund, when mingled with the funds of a trustee, in the following significant words:

"Proof that a trustee mingled trust funds with his own and made payments out of the common fund is a sufficient identification of the remainder of that fund coming to the hands of the receiver, not exceeding the smallest amount the fund contained subsequent to the commingling (Board of Com'rs v. Strawn, 157 Fed. 49, 51, 84 C.C.A. 553, 555, 15 L. R. A. (N.S.) 1100; Weiss v. Haight & Freese Co. (C.C.) 152 Fed. 479; American Can Co. v. Williams, 178 Fed. 420, 423, 101 C.C.A. 634, 637), as trust property, because the legal presumption is that he regarded the law

> and neither paid out nor invested in other property the trust fund, but kept it sacred (Board of Com'rs v. Patterson (C.C.) 149 Fed. 229, 232; Spokane County v. First National Bank, 68 Fed. 979, 16 C.C.A. 81)."

Judge Morris in the case at bar cites this very passage in support of the decision in the Circuit Court of Appeals, and although *Empire State Surety Co.* does not cite *In re Hallett's Estate*, the above excerpt reaffirms its modification of *Clayton's Case* in the most emphatic terms.

In their brief before the Circuit Court of Appeals (p. 22) the appellants cited *In re Mulligan*, 116 Fed. 715, 722.

In re Mulligan, relied upon by the appellants, presents a case of the conflicting claims of two cestui, and is consequently beside the opinion so far as the case at bar is concerned. In fact, the court recognizes the doctrine for which the appellants contend, in the following excerpt:

> "It may be reasonable that a trustee should be deemed to draw his checks against that part of a mingled account which is his own."

In their petition for certiorari to the Circuit Court of Appeals for the First Circuit the appellants rely on these two cases and *Clayton's Case*, 1 Mer. 572, ignoring its modification by *In re Hallett's Estate*, 13 Ch. Div. 143.

IN EFFECT THEY CLAIM THAT THE FORMER IS STILL IN FORCE UNMODIFIED, WHILE THEY ATTEMPT TO SUPPORT THEIR CONTENTION BY IN RE MULLIGAN, WHICH, IN THE VERY EXCERPT ON WHICH THEY RELY, THEY EXHIBIT TWO CONFLICTING EQUITIES, THE CONDITION PRECEDENT FOR THE

MODIFIED TERMS IN WHICH ALONE THIS CASE MAY BE INVOKED. Bearing in mind that in the case at bar there is no such conflict, we respectfully submit that the plaintiffs by their own authorities have established the law upon which the defendants' case rests, for the Eighth Circuit decision, in the last excerpt quoted, in affect reaffirms *In re Hallett's Estate*, as is true of the sentence quoted *supra* from *In re Mulligan* (decision in the District Court of Massachusetts, it may be observed).

It merely remains to point out that the Supreme Court of the United States has set its seal of approval upon the doctrine for which the appellee contends, in *National Bank* v. *Insurance Co.*, 104 U.S. 54.

III.

The Main Issue Becomes a Moot Question as to the Infant Defendant, Brown.

The right of an infant to disaffirm all obligation sounding in contract is absolutely beyond dispute, with the single exception relating to necessaries.

> *McGreal* v. *Taylor*, 167 U.S. 688.
> *Knudson* v. *General Motorcycle &c.*, 230 Mass. 54.

It were an act of supererogation to discuss under the Massachusetts common law the question of the voidability in cases where a different terminology is employed, for a preference suit is an action of contract *eo nomine.*

> *Jacobs* v. *Saperstein*, 225 Mass. 300.
> *Rogers* v. *American Halibut Co.*, 216 Mass. 227.

Hewitt v. *Boston Straw Board Co.*, 214 Mass. 260.

Were it necessary to invoke the law of other jurisdictions, it is enough to say that it has been held to be an implied contract under the statutory provision enabling the trustee to proceed.

Cohen v. *Small*, 120 N.Y. App. Div. 211.
Reber v. *Ellis Bros.*, 185 Fed. 313.

The refusal of the court to sanction the adjudication of an infant by involuntary proceedings (Black on Bankruptcy, 3d ed., sec. 102) justifies by perfect analogy the conclusion that no denial of the infant's immunity held sacred by common law will receive judicial cognizance. To repeat, a preference suit is not a bankruptcy proceeding. The statute merely lays down the terms on which the right of action is predicated, leaving the rest to the substantive law of the forum. The appellants assert in their brief before the Circuit Court of Appeals (p. 87) (citing Black, Bankruptcy, 2 ed., sec. 573) that the right of the trustee to recover back a preference, which is freely admitted, is a liability imposed entirely by statute, citing—

Christopher v. *Norvell*, 201 U.S. 216.

The case is beside the point, merely holding that the individual liability of a married woman as stockholder arose, not out of contract (void by state law on account of coverture), but was absolutely fixed by the National Banking Law, whereby she became liable with other stockholders by no contract with any one. It was a federal question pure and simple, and this decision has no bearing on the case at bar, in which the common law of contract is supreme.

By demanding and receiving his money back, the defendant was only exercising his right of rescission as a minor, under the age of twenty-one; and therefore no transfer was affected.

It is obvious that the dealings between Ponzi and the defendant Brown amounted to a contract, and a contract not for necessaries.

A contract of this nature the defendant had a legal right to cancel at any time during his minority, and a reasonable time thereafter.

Brown avoided the contract by withdrawing his money, thus leaving all the parties concerned in the same status as if there had been no transaction at all. This is based on the theory that the contracts of minors are voidable until avoided.

The trustees cannot hold the defendant Brown for the $600 deposited by the infant Gross.

It was admitted at the trial that $600 deposited by Gross belonged to him, and that Brown, upon cashing the check for $1200, returned half to Gross.

It seems to the appellees that, to sustain a suit on the note against Brown on his (Brown's) note, the trustees must prove the note they rely upon belongs to defendant Brown. On this point the evidence is entirely against the plaintiffs, for Brown testified that "he did not know whether he invested his own note of $600 on the twentieth or the twenty-fourth day of July."

Respectfully submitted,

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